

The Honorable Ben S. Bernanke  
Chairman, Board of Governors  
Federal Reserve System  
20<sup>th</sup> Street and Constitution Ave, NW  
Washington, DC 20551

The Honorable Mary Jo White  
Chairman  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

The Honorable Martin J. Gruenberg  
Chairman  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, NW  
Washington, DC 20429

Thomas J. Curry  
Comptroller of the Currency  
U.S. Department of the Treasury  
250 E Street, SW  
Washington, DC 20219

The Honorable Jacob J. Lew  
Secretary  
United States Department of the Treasury, and  
Chairman Financial Stability Oversight Council  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

Re: Proposed Rule, Credit Risk Retention  
OCC Docket No. 2013-1101; Federal Reserve Docket No. R-1411;  
FDIC RIN 3064-AD7; SEC File No. S7-14-11; FHFA RIN 2590-AA43

Dear Sir or Madam,

The signatories below are among the largest and most active participants in the structured real estate credit markets that emerged in the wake of the RTC-era crisis. Collectively, our firms have managed more than \$100bn of our own and investor capital throughout the real estate cycle. The majority of these funds target long-term investments in various real estate related sectors. We are control investors. We actively service, special service and asset manage property and loan portfolios as principals and for the benefit of third party investors.

We would first like to thank the numerous representatives of your agencies for their thoughtful and open-minded approach to the highly complex and economically crucial task of implementing the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). While many of us have other businesses affected by the Act, we write collectively today strictly in regard to the Proposed Rule for the CMBS markets.

While we are competitors in the marketplace, we write together in a hope that our collective voice might provide some clarity as to certain important aspects of the Proposed Rule, around which we believe conflicting views have been put forward by other parties.

In several past discussions, various agencies have requested specificity as to where misalignment/conflict with best-practices exists, how the Proposed Rule addresses these issues and what are likely market impacts. While we are, of course, simply expressing our opinion on past and future market events and on the potential actions of numerous market participants, we will attempt to frame our opinions based on past experience and observation of how the market prices various risk exposures, options, etc.

The messages we hope to convey are based on a relatively simple set of common precursors:

- I. The powerful tools of structured finance have been critical to the growth of the United States economy since the 1980's. "Origination-for-Sale" ("OFS") lending represents a vital component of modern credit markets. With proper management and incentive structures, OFS lending helps democratize the provision of credit throughout the economy. In many sectors, OFS lenders have and will continue to play vital roles in rebuilding credit provision in the post-crisis recovery.
- II. Despite its important contributions to the economy, the OFS process has displayed several systemic flaws related to originator and "securitizer" incentives when compared with the traditional credit provision and asset management practices of well-run "balance sheet lending" processes.
- III. Powerful statistical evidence exists validating that balance sheet credits outperformed similar OFS credits across nearly every sector during the crisis. Evidence also exists that credit, servicing and asset management practices typical of the balance sheet lending model play an important part in this outperformance.<sup>1</sup>
- IV. The Act's CMBS-related provisions and the Proposed Rule are intended to create regulation that in an efficient manner achieves the following:
  1. Minimizes future risk of systemic creation of poorly structured credits via the OFS markets, with the following underlying goals:
    - i. Minimizing future likelihood of imprudent leverage levels over-heating commercial real estate markets;
    - ii. Minimizing volatility, illiquidity and loss severity in future market downturns;
    - iii. Limiting market exposure to aggressive debt structures.
  2. More closely aligns economic and incentive models between balance sheet lenders and OFS lenders by:
    - i. More closely equating paid-in capital ratios;

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<sup>1</sup> See Exhibit 1 for the performance of Multifamily Delinquencies, and Exhibit 2 for Commercial Real Estate (CRE) delinquencies

- ii. Better enforcing “skin-in-the-game” incentives through the maturity and repayment of CMBS credits;
  - iii. Encouraging the reasonable and efficient management of troubled/defaulted credits.
- V. Modern capital markets are highly resilient and efficient in responding to change. Market changes resulting from well-designed and easily understood new regulations will be quickly met with appropriately priced capital from across the debt and equity spectrum. Creating numerous exceptions in the rules and/or rules that run contrary to one another will stifle capital formation and make compliance and enforcement less efficient.

The risk retention requirements that form the economic core of the Proposed Rule are workable in the market and effective in achieving the Act’s goals. If the Proposed Rule were simply to require 5% economic retention, capital would quickly form to address any market changes. However, certain proposed qualifications to retention, as well as several governance aspects of the Proposed Rule, serve to undermine the incentives that retention intends to foster and would likely have negative market impacts. As such, we break our comments into two major sections: Risk Retention and Governance.

## **Risk Retention**

### **Market Observations Related to Risk Retention**

“Risk Retention” and the accompanying alignment of incentives formed the initial construct around which pooled CMBS were created. The B-Piece/Special Servicer model was introduced in 1993 -- Phoenix Home Life 1993-1 with LNR Property affiliates as B-Piece Buyer/Special Servicer. Rating agencies and senior bond buyers took confidence in the abilities and aligned incentives of a sophisticated B-Piece investor who acquired the first loss risk based upon its loan-by-loan underwriting and ability to efficiently resolve troubled loans. This checks-and-balances model based on *Risk Retention* and specialized *Capabilities* worked well in its first decade. For shorthand, we call it the “RRC Model.”

With the benefit of hindsight, we can see that by 2006 levels of leverage in use largely relieved B-Piece buyers of their “skin-in-the game.” The fact that real retention and its alignment of incentives in credit selection had largely disappeared was a major fracture point of CMBS credit in the run up to the crisis.

The RRC Model of the B-Piece investor’s underwriting, workout ability and investment discipline remains core to credit considerations in CMBS 2.0. In fact, other sophisticated investors have submitted comments on the Proposed Rule stating that it is not feasible for investors other than the B-Piece investor to review

credit on a loan-by-loan basis. Since CMBS 2.0 transactions are selling briskly, we conclude investors are still broadly relying on the RRC Model to gain credit comfort.<sup>2</sup>

Amidst the strong current demand for CMBS 2.0 credits, B-Piece sizing is approximately 2.7% of economics and 7% of notional balance – i.e. 37:1 leverage on paid-in capital. Assuming no significant term defaults, this level of structural leverage allows the B-Piece buyer to recover the principal of his or her investment from coupon payments during the term. As such, avoiding term defaults is the primary underwriting concern; repayment at maturity is secondary. While DSCRs remain high due to historically low coupon rates, LTVs are increasingly approaching 2006 levels.<sup>3</sup> In addition, loan pools increasingly contain credits with late term rent roll risk and/or single tenant exposures. These risks, as well as historically low coupons, lead to more difficult refinancing scenarios in a normalized interest rate environment.

Our specific comments to aspects of the Proposed Rule related to retention follow:

- Risk Retention Issues in the Proposed Rule

Retention Works: The proposed rule for a B-Piece equity investment equal to 5% of the proceeds of a CMBS securitization efficiently and effectively advances the goals of the Act. Limiting CMBS “paid-in-capital” leverage ratio to no greater than 19:1 is reasonable and prudent. Given the cash flows of a typical CMBS structure, a B-Piece sized to 5% of proceeds (market value) insures, outside a severe stress scenario, that the B-Piece holder still has significant “skin-in-the-game” at the maturity date of the underlying collateral. If the Proposed Rule were simply to require 5% retention, sufficient capital is available in the market to absorb the additional B-Piece size at appropriate yields.<sup>4</sup>

Predictions of materially increased borrowing costs and/or broadly decreased competitiveness of OFS lenders as a result of retention are not consistent with current market conditions. To illustrate this, we provide in Exhibit 5 the output from a financial model of a sample CMBS transaction with loan characteristics, bond pricing and securities structure inputs reflecting current market conditions and inputting 5% retention under various scenarios. The underlying model is substantially equivalent to those employed by the most sophisticated OFS lenders in

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<sup>2</sup> While CMBS 2.0 transactions contain approximations of the governance elements of the Proposed Rule (appraisal-based control mechanism, operating advisor functions, etc.), none of these have any direct bearing on credit selection or enhance skin-in-the-game incentives.

<sup>3</sup> See Exhibit 3 for Moody’s Stressed Conduit DSCR and Exhibit 4 for Moody’s Stressed LTV.

<sup>4</sup> Certain governance provisions of the Proposed Rule discussed below would have negative consequences for capital formation.



pricing loans and by securities dealers in structuring and pricing securities sold to investors. The base case scenario, Pricing Run 4, uses the most likely bond pricing scenario; creating equivalent securitization profits from the same loan pool requires approximately 8 bps of additional coupon. The highly-unlikely worst case scenario, Pricing Run 3, prices incremental B-Piece securities assuming none of the numerous competitors in the B-Piece market would ascribe lower yields to the senior, incremental securities purchased; the profit-equalizing coupon is only 30 bps higher.

Consistent with the thoughtful comments you have received from several other large market participants, we believe that the positive impacts of retention will likely lead to increased demand for senior CMBS bonds. Over a relatively short period, we believe it is more likely than not that this demand actually reduces overall cost of funds for OFS lenders. Applying only slightly improved bond pricing (Pricing Run 5) brings the likely cost of retention to 4 bps.

Pari Passu Participation: The proposed ability to split the 5% B-Piece between two pari passu participants likely will be helpful at the margin to several current market participants and potential new entrants. With proper governance procedures amongst the holders, the regulatory goals are relatively unaffected. In any case, no material market movements are likely with or without pari passu sharing.

Senior / Subordinate Participation: On the contrary, providing an ability to split the B-Piece on a senior/subordinate basis would nullify the regulatory intent of 5% retention. Retention of 2.5% of proceeds is actually smaller than the B-Pieces sold in recent CMBS transactions. The potential control volatility between senior-sub participants even in a relatively mild stress scenario seems contrary to the Act's goals.<sup>5</sup>

- QCRE Issues in the Proposed Rule

QCRE and CMBS B-Piece Exemption Are Incompatible: We believe QCRE is intended to operate in single originator-sponsored securitizations -- not to reduce the size of third party B-Pieces for multi lender securitizations. Allowing a reduction in risk retention for pools of QCRE loans comingled with non QCRE loans will unnecessarily reduce the ultimate retention associated with such non QCRE loans. CMBS lenders will add QCRE loans to multi borrower pools solely to reduce the retention requirement on the whole pool, circumventing the retention requirement.

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<sup>5</sup> Additionally, senior/subordinate structuring of the B-Piece would likely nullify the enhanced CMBS demand outlined in Exhibit 5, Pricing Run 5.

Since the CMBS market's beginnings in the mid-1990s, originators and subordinate risk buyers have negotiated thousands of transactions with special pricing provisions for large and high quality loans, ie QCRE loans. Based on this precedent, pricing QCRE loan attributes into a 5% B-Piece is easily accommodated by existing market practices both in Single Borrower and Pooled CMBS. Predicting that high quality loans will be forced out of the CMBS market absent QCRE carve-outs is not consistent with this history.

Numerous retention carve-outs and exceptions will dilute the market discipline and investor confidence that retention is designed to enhance. In particular, the following should be considered:

- Compliance and enforcement of retention rules with QCRE carve-outs seems unnecessarily complex;
- Seemingly a high potential for misaligned incentives exists near the margins of QCRE parameters; and
- New QCRE parameters will be required, see below.

Single Borrower CMBS ("SBCMBS"): If it is determined that the Act requires QCRE carve outs *in addition to* the third party B-Piece option, QCRE should only apply in high quality SBCMBS. SBCMBS significantly outperformed other OFS credits over the crisis. Additionally, the typical origination and marketing processes for SBCMBS have high transparency for all investors and are less exposed to misaligned incentives than the pooled credit CMBS process.

New QCRE Parameters Are Required: Again, if it is determined that the Act requires QCRE, the proposed QCRE parameters seem based on metrics from other markets and are not generally applicable to CMBS credits. Only *LTV*, *DSCR* and/or *rating* parameters might have general application, but none even of these uniformly enhances the CMBS process pursuant to the Act's intent. While *Loan Term*, *Amortization Term*, and *Appraisal Cap Rate* may apply to credit or investment considerations in specific instances, none would be a first order consideration for CMBS investors. It should be noted that past performance statistics show that credit parameters with high predictive power are hard to identify in pooled CMBS; even *LTV* and *DSCR* display lower-than-anticipated performance correlations. Recent work by Moody's displays higher predictive power for their *Stressed LTV* and *Stressed DSCR* parameters, but it is still less than would be required to parameterize a bright-line rule like QCRE.

## Governance

The Proposed Rule includes several CMBS governance components we collectively refer to as the “Governance Proposals”: appraisal-based voting metrics, Operating Advisor (“OA”) functions, servicing change voting procedures, servicer restrictions, etc. We generally support these governance developments as they have been negotiated between market participants and successfully implemented in CMBS 2.0 transactions. As currently drafted, however, the Governance Proposals mandate governance provisions that could potentially inject perverse cash flow timing incentives into the CMBS structure and/or could lead to chaos in the management of troubled loans. We will attempt to highlight these negative aspects in the context of market history, current trading activity and hypothetical scenarios of the Governance Proposals’ possible function.

## Market Observations Related to Governance

Unfortunately, the calls for various governance structures favoring senior certificates in a future downturn have been more characterized by hyperbole and unsubstantiated anecdote than any other part of the post-crisis discussion of CMBS. Discussion of various governance reforms began soon after the crisis low point for CMBS in late November 2008, when recent vintage Super Senior bonds traded as low as mid-50 dollar prices. It was not surprising that the loudest voices alleging governance failures, in particular that the Servicing Standard required faster liquidation of defaulted credits, were those of the recent buyers of deep-discount Super Seniors – these investors stood to make windfall profits from prepayments of their discount bonds.

What was surprising, however, was the credence given these voices in that what these sophisticated institutional investors were calling for was totally contrary to the basic premise of the securities architecture in which they had invested. The CMBS structure, Servicing Standard and rating methodology are explicit: the securities pay *current interest* and *eventual principal*. CMBS have *stated final maturity* of 30+ years because the Servicing Standard explicitly provides that NPV of total recoveries<sup>6</sup> takes precedence over cash flow timing. Indeed, this priority is a fundamental precedent consistent across structured credit securities. In addition,

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<sup>6</sup> The NPV calculation uses the loan coupon rate as the discount factor, which rate, in almost any instance, would be far lower than the discount rate used by a buyer of the distressed asset. The purpose of a clearly lower than market discount rate was to quantify in the Servicing Standard’s operation a bias toward longer-term workout strategies designed to minimize principal losses and thereby protecting, to the degree possible, the notional subordination below the investment grade bonds. The fundamental theory of CMBS architecture and rating methodology depend on the Special Servicer acting to maintain the credit support of the senior certificates. As such, the architecture and rating methodology contain an explicit and intentional bias against cash flow timing considerations. Hence, CMBS indentures specifically provide for timely payment of interest but only eventual payment of principal, therefore necessitating CMBS certificates having stated final maturities of 30+ years.

cash flow timing is not a first order consideration in any insolvency regime of which we are aware.

If calls for new governance structures had been accompanied by repeated evidence of malfeasance or by statistics indicating systemic servicing malfunctions, the discussion of the Governance Proposals may have had a more rational basis. However, no such evidence has been presented. Indeed, to our knowledge, the anecdotal claims of systemic malfunction (e.g. – servicer responsiveness, failure to comply with servicing standards, etc.) have largely been discredited.

In regard to governance and servicing, we believe that the vast majority of factual evidence and statistics indicates that CMBS, its structure and its servicers have outperformed other OFS credit products. Market events decisively validate this outperformance:

- 2007 vintage A4s, which traded as low as mid-50s dollar prices in November 2008, trade materially above par today;
- CMBS credit models currently predict that ALL 2008 and prior vintage Super Seniors will recover 100% of principal;
- Models also predict that nearly all 2008 and prior vintage AMs and most AJs are likely to recover 100% of principal;
- Many of the Investment Grade Buyers who are alleged to support the Governance Proposals own and trade 2008 and prior vintage CMBS today;
- CMBS 2.0 sell briskly to many of the same Investment Grade Buyers based on market negotiated parameters approximating most aspects of the Governance Rules.

With these healthy market facts in mind, we urge consideration of two hypothetical market scenarios which assume the Governance Proposals had existed for 2007 and 2013 vintage CMBS:

2009 Scenario:

- Investors who owned deep-discount 2007 vintage Super Senior AAAs (which AAAs represent approximately 70% of the outstanding certificates in each securitization structure) voted to replace special servicers seeking appointment of servicers favoring fast liquidations;<sup>7</sup>

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<sup>7</sup> Supporters of the Governance Proposals likely will attempt to minimize the consequences of servicer replacement by pointing out that any new special servicer would be required to comply with the Servicing Standard. While this is on its face true, it is also somewhat disingenuous in that these investors know that a bias toward fast liquidations would in any event be easy to construct within “reasonable man” boundaries for forward-looking decisions under the Servicing Standard. When challenged in this manner, they would rightly respond that the Special Servicer and B Piece holder could equally bias forward-looking assumptions to fit their own loss mitigation objectives. In doing this, however, they expose the gap in their logic. As mentioned previously, CMBS architecture and rating methodology explicitly prioritize loss mitigation over cash flow timing. Loss mitigation

- Following the cash flow timing wishes of the senior bonds, newly selected servicers liquidated vast pools of defaulted collateral into the worst period of the crisis.

The results of this scenario are clear:

- Far greater losses and volatility would have occurred;
- Small OA firms (as exist today) would have had no capability of assessing whether collateral pricing was fair or not; and at the margin, their prepayment-focused clients (the Super Senior holders) would not have cared;
- While mezzanine and subordinate AAA classes would have largely been wiped out, a few opportunistic/vulture senior investors would have made short-term windfalls; and
- CMBS and CRE markets generally would have been far worse off as loan workout efforts devolved into chaos with borrowers shunning workout discussions in the hope that a fast liquidation strategy would lead to a deep discount sale of their loans.<sup>8</sup>

#### 2018 Scenario:

- Imagine a 1978-type stagflation environment with high CRE vacancies;
- 5s/10s UST curve flat at 10%;
- 5 year collateral loans cannot refinance and term defaults are trending up due to high vacancies;
- 3.5% coupon 2013 vintage A3s trade at 50 dollar price;
- Super Senior holders (about 70% of outstanding) vote to replace the special servicer seeking a replacement servicer favoring quick liquidation of defaulted collateral;
- Defaulted loans and REO are liquidated into the teeth of the downturn.

Despite the different economic circumstances in this scenario, the results for CMBS and CRE markets are similarly catastrophic:

- Liquidations generate windfall profits for Super Senior investors via prepayments on their deep discount securities;

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performed by a capable and motivated special servicer to protect the subordination credit support below the investment grade bonds is the core economic construct around which the CMBS architecture and rating methodology are based. It is why the securities have 30+ year stated final maturities.

<sup>8</sup> Defaulted borrowers often see the discount sale of their note as an opportunity to negotiate a discounted payoff based on the acquirer's discount basis. This market practice was quite common in the RTC era, but it has rarely occurred in the work out of CMBS loans.

- Pricing of default recoveries is subordinated to cash flow timing considerations of Super Senior investors;
- Liquidations generate large losses that wipe out junior and mezzanine bonds and erode credit support;
- Distressed sales in CRE markets erode prices and further depress leasing, thereby spurring additional defaults; and
- Defaulted loan workouts are stymied by borrowers hoping for advantage in a fast liquidation scenario.

Avoiding perverse cash flow timing motivations of this type<sup>9</sup> and encouraging a longer term path to stability is why the CMBS structure and Servicing Standard give priority to NPV of total recoveries and subordinate cash flow timing considerations. In 1993 when that priority was established, 1978 and 1989 were not that distant a memory. Unfortunately, the Governance Proposals inject the potential for perverse incentives to play out in the CMBS structure and to create chaos in the servicing of defaulted loans.

In summary regarding the Governance Proposals, we urge consideration of the following:

- If only in terms of managing and resolving the vast numbers of defaulted credits, the CMBS servicing and governance model has performed relatively well through the crisis – better than we would have assumed at the depth, and far better than other sectors of OFS credit markets.
- To our knowledge, the interest groups lobbying for the Governance Proposals have produced neither factual evidence nor meaningful statistics to support claims that the CMBS governance model failed in any systemic way in relation to the Governance Proposals.<sup>10</sup>
- Sophisticated institutional investors bought securities with structure, governance and Servicing Standard each clearly providing that cash flow timing was not the first order priority. Accordingly, the securities they purchased had stated final maturities of 30+ years.
- The market results actually point to a resilient structure and functioning governance where senior securities are currently trading materially above par. Many Investment Grade Buyers own and trade these bonds at these prices, which would seem to contradict the need for the Governance Proposals;
- Mandating governance fundamentally contrary to CMBS architecture that potentially injects perverse cash flow incentives will materially damage investment demand for Mezzanine CMBS and B-Pieces. It is difficult to imagine how a thoughtful investor could invest upwards of \$50 million in a single B-Piece with governance providing a path for other investors to

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<sup>9</sup> As well as the vicious circle results of market erosion, volatility and increased defaults.

<sup>10</sup> We say this particularly as to servicing and governance and as distinct from the failure of the OFS model to maintain credit discipline.

determine who services defaulted loans. Indeed, taking that risk would amount to exactly the type of speculation that the Act and the Proposed Rule intend to discourage.

We recognize that appraisal-based voting control mechanisms, Operating Advisor consulting rights and other general aspects of the Governance Proposals are broadly agreed upon by market participants and the regulatory community. We believe this coalescing of interests has been a positive force in the market. In concert with this, stakeholders in the CMBS 2.0 market have negotiated terms acceptable to all market participants, all sophisticated institutional investors, that approximate the basic aspects of the Governance Proposals but minimize the perverse incentives discussed above. In particular, Investment Grade Buyers have purchased many billions of CMBS 2.0 on these terms; this market action amongst sophisticated investors seems to contradict the case for the Governance Proposals as drafted.

Our specific comments as to certain aspects of the Proposed Rule related to Governance follow:

- Voting Quorum to Replace the Special Servicer: Under the Proposed Rule, the Special Servicer could be removed at any time based upon the recommendation of the Operating Advisor by an “affirmative vote of a majority of the outstanding principal balance of all ABS interests and require a quorum of 5 percent of the principal balance of all ABS interests.”

We are strongly opposed to this radical and unprecedented concept. Requiring 5% equity retention that cannot be sold but at the same time mandating governance that allows 5% of senior debt investors to remove the servicer of distressed credits is contrary to logic. The point of creating a larger B Piece investment is to tie the buyer’s incentives to full recovery of principal at maturity. Controlling the work out of defaulted loans is integral those incentives. The radical nature of this proposal should be clear in that it is effectively equivalent to regulation mandating corporate governance providing that 5% of the debt holders of a company could vote to remove the CEO and management team at any time.

No evidence of systemic servicing or governance failure<sup>11</sup> has been presented by any party that provides a rational basis for such a radical change to the CMBS architecture and the successful market practices found in CMBS 2.0. In the absence of such evidence, creating such powerful regulation based upon the lobbying efforts of a specific group of sophisticated institutional investors who would appear not to have understood the basic architecture of

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<sup>11</sup> Again we want to highlight that we make this statement ONLY in terms of servicing and governance, not in terms of systemic issues around credit selection which we believe are substantially addressed by the 5% retention requirement.



securities they purchased would be a terrible precedent. The gravity of such precedent is particularly highlighted by the following market facts:

- The proposed regulation stands precedent across all markets and insolvency regimes on its head; control rests with equity and migrates sequentially from junior to senior as the value that supports each class is shown to have been eroded;
- All of the senior certificates at the focal point of the proposed regulation will recover 100% of principal and trade today at prices well above par;
- Many, if not all, of the sophisticated institutions lobbying for the regulation are active investors in markets for both legacy CMBS and CMBS 2.0; and
- The proposed regulation would largely relieve institutions of their primary responsibility in the markets to vote with their feet. If securities have inadequate governance structures, sophisticated institutions should not be buying them.

The Proposed Rule should mirror CMBS 2.0 transactions in which nearly all the Investment Grade Buyers currently invest. CMBS 2.0 transactions typically provide that (i) the Operating Advisor may recommend a vote to remove the Special Servicer only after the senior-most tranche of the B-piece position has been reduced to less than 25% of its initial principal balance (which would be the equivalent of reduction of Eligible Horizontal Residual Interest (“EHRI”) balance to less than [10%] as discussed below) and (ii) the Special Servicer can be removed after such vote only if more than 50% of the aggregate outstanding principal balance of all classes affirmatively vote for such removal (i.e. holders of at least a majority of the aggregate outstanding balance of the CMBS securities must participate in the vote and vote in the affirmative).

In any event, governance should be based on quorum and voting mechanisms that mitigate differential incentives of senior certificates relative to the junior and mezzanine holders, incentives which would nearly always be at odds in any stress environment. In addition, if the threshold event described in clause (i) above is to be expressed in the rules in terms of a reduction in the principal balance of EHRI, rather than the principal balance of the senior-most B-Piece tranche, the threshold percentage should be set as described below under “Trigger for Operating Advisor Consultation Rights.”



- Trigger for Operating Advisor Consultation Rights. Under the Proposed Rule, the Special Servicer must consult with the Operating Advisor with respect to material servicing decisions “when the eligible horizontal residual interest has a principal balance of 25 percent or less of its initial principal balance.” This is a significant deviation from current market practice as to when the Operating Advisor’s consultation rights are triggered. The current market practice requires the Special Servicer to consult with the Operating Advisor when the senior-most tranche of the B-piece position, not the aggregate of the B-piece position, has been reduced to less than 25% of its initial principal balance (either notionally, as a result of appraisal reduction amounts, or as a result of realized losses). If we use Exhibit 5 as an example of a typical CMBS 2.0 structure for the purposes of this analysis, 25% of the senior-most tranche of the B-Piece position would equate to approximately 8.1% of the aggregate B-Piece position.

If reduction below 25% of the EHRI (either notionally, as a result of appraisal reduction amounts, or as a result of realized losses) is used as the threshold for triggering Operating Advisor consultation rights, the B-Piece buyer becomes subject to Operating Advisor consultation rights much sooner than is current market practice. At the same time, the Proposed Rule doubles the amount of the B Piece investment in each transaction. We propose maintaining the same economic starting point for the Operating Advisor consultation trigger that has been successfully negotiated between the institutional participants in CMBS 2.0. We believe that the proper sizing of the commencement of consultation rights should be when the EHRI has a principal balance of less than 10% of its initial principal balance.

- B-Piece Buyer Affiliations: Under the Proposed Rule a third-party purchaser of the EHRI would be barred from being affiliated with a lender that contributes more than 10 percent of the loans to that deal. This provision runs counter to the underlying rationale for the concept of risk retention namely “skin in the game.”

It is the clear intent of risk retention requirements in conjunction with the third party B-Piece option to inject long-term principal incentives into OFS lending markets. This transference occurs via the B-Piece buyer setting credit quality standards for what it will buy from OFS originators. If loans do not meet its standards, the B-Piece buyer kicks them out.<sup>12</sup> Since typically an originator will lose 10 points or more on kick out loans, OFS originators are indirectly drawn into “skin in the game.”

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<sup>12</sup> To gain this “B-Piece perspective” and avoid kick outs, the best OFS lenders regularly consult with frequent B-Piece investors to get their input before making a loan they believe might be near B-Piece buyer credit tolerances.

Given the clear intent of retention to transfer “skin in the game” to OFS originators, it is contrary to logic to restrict a lender who is directly operating with these incentives based on that lender’s Day 1 intent to hold the credit risk on its loans for the long term. Market participants have broadly supported CMBS 2.0 transactions to which a B-Piece buyer affiliate has contributed a significant pool of loans. This should not be surprising; Investment Grade Buyers have invested in these transactions saying they value the originator/B-Piece buyer’s Day 1 commitment to its loans as it amounts to more “skin in the game.”

At our December meeting with assembled agencies, it was mentioned that certain “senior investors” support this proposal based on a belief that “two sets of eyes” – the originator and the B-Piece buyer – leads to better underwriting. This reasoning is economically flawed. The proper micro-economic analysis is as follows:

- OFS originator is a short-term-focused seller;
- B-Piece investor is a long-term-focused buyer;
- In relation to each individual transaction between them, the economic interest of these parties is diametric;
- 5% Retention serves to significantly increase the long-term focus of the B-Piece investor by marrying its returns to principal recoveries at maturity;
- Retention has a powerful indirect effect in OFS origination markets because the OFS originator must consider the credit view of a long-term holder based on the originator’s exposure to kick outs;
- While this represents a significant improvement in the OFS incentives model, retention does not equate the diametric incentives of the buyer and seller;
- If, however, the loan originator and the B-Piece investor are the same person, by definition origination decisions will be made based on the incentives of a long-term holder;
- Therefore, since it is the Act’s clear intent to inject long-term principal incentives to OFS lending markets, it is logical to encourage wherever possible lending based directly on this alignment.

Finally, in terms of the regulatory goals of the Act, there is no rational nexus between this proposal and any of the pre-2008 issues in CMBS markets that the Proposed Rule intends to address. No evidence, statistics, nor even anecdotal account of market failure has been put forward by any party that has any reasonable relation to this proposal. Indeed, quite the contrary is true. Had originators during the 2006 to 2008 period also been B-Piece buyers, this almost certainly would have shined a brighter light on market excesses of that period.

## **Conclusion**

For CMBS to be a consistent and positive force in the markets and to reduce volatility in future downturns, the B-Piece buyer and CMBS architecture overall must be aligned with full term performance of the loans, recovery of principal at maturity and the effective management of defaulted credits. 5% Retention, as the fundamental economic element of the Proposed Rule, achieves this alignment. On its own, 5% Retention is efficient and effective in achieving the goals of the Act, and it is easily accommodated in the current market environment. All other aspects of the Proposed Rule should be designed to enhance "skin in the game" incentives that come with retention. Proposals that complicate the retention construct or run counter to "skin in the game" should be seriously weighed as to their necessity. Certain aspects of the Governance Proposals are highly disruptive and largely unnecessary based current market structures -- CMBS 2.0 has crafted a governance paradigm around these issues that has satisfied all of the sophisticated institutions who participate in the CMBS markets.

Thank you for your time and consideration.



**Tobin Cobib**  
Co-Chief Executive Officer  
Grass River Property



**Justin Kennedy**  
Co-Chief Executive Officer  
Grass River Property



**Boyd Fellows**  
President  
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**Cory Olson**  
President  
LNR Property, LLC

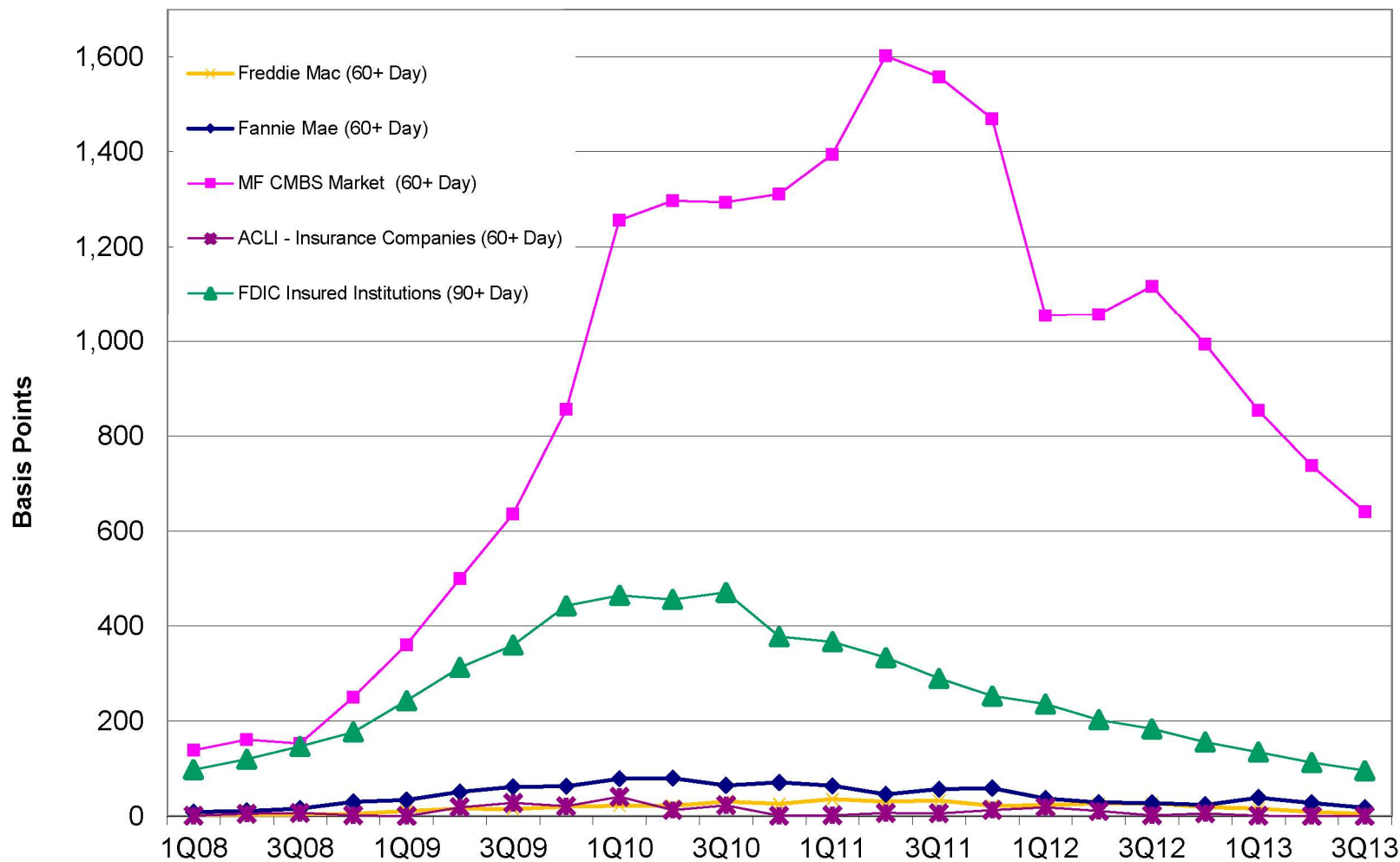


**Paul Blenio**  
Chief Financial Officer  
Arbor Commercial Mortgage, LLC



**Chase S. Curtis, Jr.**  
Chief Credit Officer  
ISTAR Financial

# Exhibit 1: Multifamily RE Delinquency Rates



## Sources:

FDIC Insured Institutions: FDIC Quarterly Banking Profile - Loan Performance Data

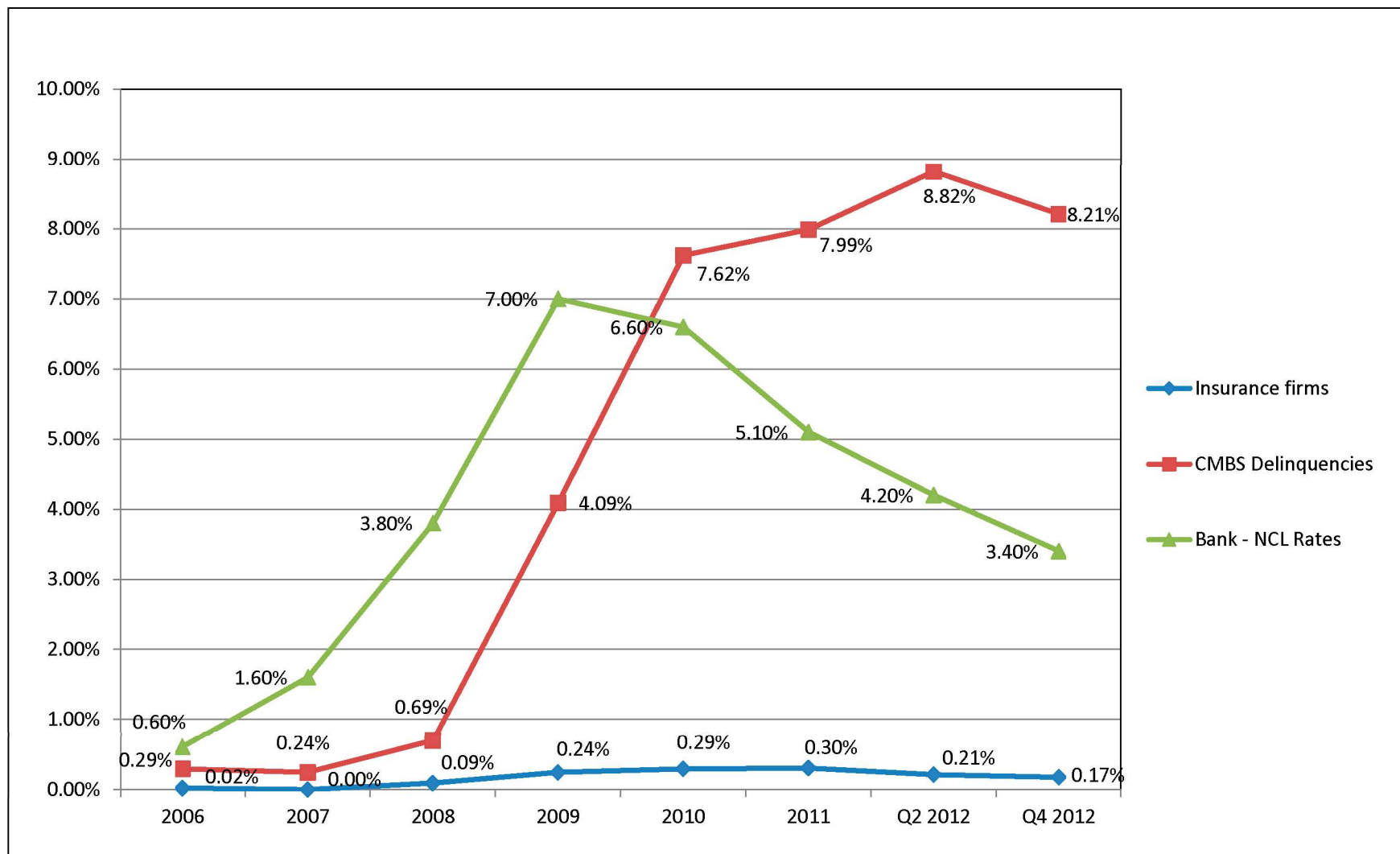
MF CMBS Market: TREPP. 60+ days, in foreclosure, REO, or non-performing balloons

Fannie Mae: Delinquency rate from SEC filing

Freddie Mac: Multifamily delinquency performance is based on the UPB of the total Multifamily mortgage portfolio

ACLI: Fourth Quarter 2011 ACLI Investment Bulletin

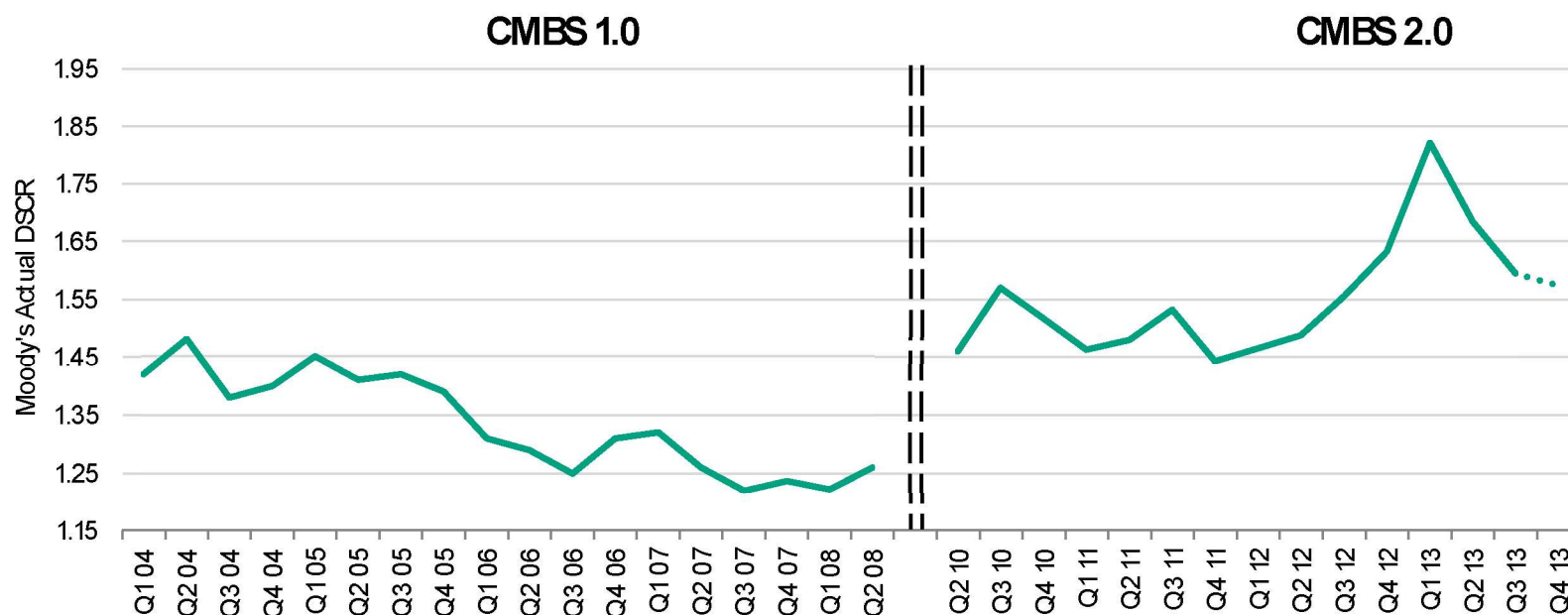
## Exhibit 2: CRE Delinquencies (90+ Days)



Note: CMBS Delinquencies include Foreclosure, REO, Non Performing Balloon Loans  
 Bank - NCL (Non Current Loan) Rates includes 90+ days delinquent and Non Accrual Loans.

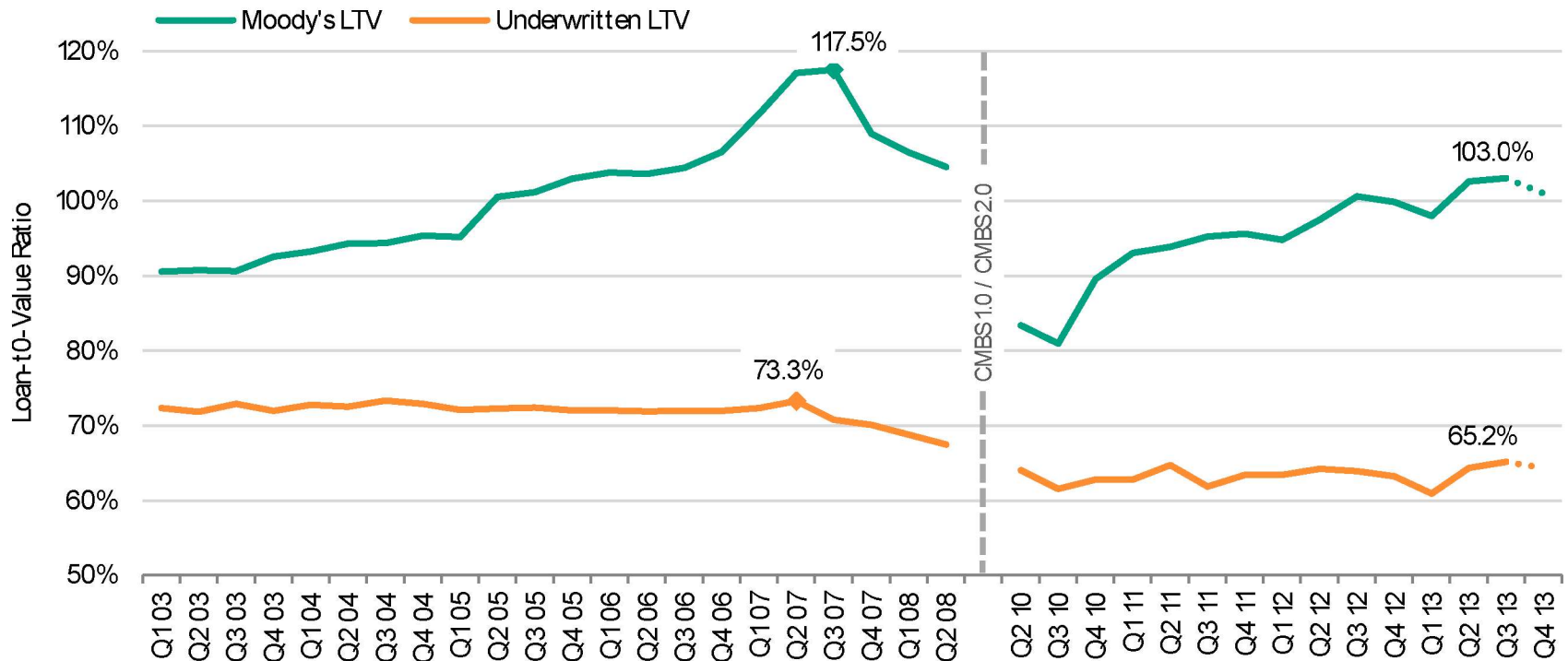
## Exhibit 3: MDSCR Declining but Still Well Above Average

- » Term default risk increasing as DSCR decreases
- » Given high DSCR and recovering fundamentals, loan credit quality overall aligns with 2005, but can quickly shift to 2006 quality as DSCR declines



## Exhibit 4: Conduit Loan Leverage

- » Q3 MLTV, our measure of loan proceeds per dollar of stabilized cash flow, aligns with early 2006
- » Both underwritten LTV and MLTV trending flat to slightly down in Q4





## Exhibit 5: Retention Analysis - 76.8% 10 Year Loans

### Pricing Run 1: Current Projected Pricing - 7.00% B-Piece at 17% Yield

Class Name	Ratings	C.E. Level	Size	Original Balance	Coupon	WAL	Swap Rate	Yield	Duration	Credit Spread/Yield	Final Price \$	Bond Price %
A-1	AAA	30.0000%	5.81%	48,679,011	1.101%	2.816	0.543%	1.093%	2.557	55.00	48,678,419	99.999%
A-2	AAA	30.0000%	22.26%	193,040,383	2.962%	4.877	1.407%	2.307%	4.502	90.00	198,827,367	102.998%
A-3	AAA	30.0000%	35.60%	308,666,653	4.122%	9.812	2.778%	3.773%	7.989	99.55	317,916,261	102.997%
AAB	AAA	30.0000%	6.52%	56,535,645	3.681%	7.469	2.286%	3.2356%	6.436	95.00	58,228,436	102.994%
AM	AAA	22.0000%	8.00%	69,362,479	4.544%	9.919	2.797%	4.197%	7.875	140.00	71,441,769	102.998%
B	AA-	15.7500%	6.25%	54,189,437	4.776%*	9.919	2.797%	4.747%	7.728	195.00	54,812,233	101.149%
C	A-	11.8750%	3.88%	33,597,451	4.776%*	9.919	2.797%	5.247%	7.663	245.00	32,699,452	97.327%
D	BBB-	7.0000%	4.87%	42,267,761	4.776%*	9.919	2.797%	6.797%	7.458	400.00	36,583,695	86.552%
E	BB	5.0000%	2.00%	17,340,620	4.250%	9.919	2.797%	17.000%	6.222	17.000%	7,015,638	40.458%
F	B	4.0000%	1.00%	8,670,310	4.250%	9.919	2.797%	17.000%	6.222	17.000%	3,507,819	40.458%
G	NR	0.0000%	4.00%	34,681,239	4.250%	9.919	2.797%	17.000%	6.222	17.000%	14,031,276	40.458%
IO-A	AAA	-	-	676,284,170	1.196%	7.455	2.166%	3.916%	3.581	175.00	43,447,154	6.424%
IO-B	AAA	-	-	130,054,648	0.000%	9.669	2.665%	5.365%	-	270.00	-	0.000%
IO-C	AAA	-	-	17,340,620	0.526%	9.669	2.680%	8.805%	4.429	612.50	687,149	3.974%
IO-D	AAA	-	-	43,351,549	0.526%	9.731	2.693%	18.193%	3.569	1550.00	1,211,317	2.806%
Total				867,030,987							889,087,986	102.544%

Face Needed	Value Needed	Agg Econ Value	Face %
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
22,991,508	19,899,666	5.00%	54.39%
17,340,620	7,015,638	2.76%	100.00%
8,670,310	3,507,819	1.97%	100.00%
34,681,239	14,031,276	1.58%	100.00%
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
83,683,677	44,454,399	5.00%	

### Pricing Run 2: Pricing at 17% Yield up to Single A (12.09% of the Deal) - Average loan spread 34.2bps wider

Class Name	Ratings	C.E. Level	Size	Original Balance	Coupon	WAL	Swap Rate	Yield	Duration	Credit Spread/Yield	Final Price \$	Bond Price %
A-1	AAA	30.0000%	5.31%	46,025,938	1.102%	2.620	0.544%	1.094%	2.561	55.00	46,025,185	99.998%
A-2	AAA	30.0000%	22.32%	193,518,543	2.962%	4.877	1.407%	2.307%	4.502	90.00	199,319,831	102.998%
A-3	AAA	30.0000%	36.12%	313,147,428	4.122%	9.813	2.778%	3.774%	7.970	99.55	322,527,644	102.995%
AAB	AAA	30.0000%	6.25%	54,229,784	3.683%	7.475	2.287%	3.2373%	6.441	95.00	55,856,087	102.999%
AM	AAA	22.0000%	8.00%	69,362,479	4.544%	9.919	2.797%	4.197%	7.875	140.00	71,441,769	102.998%
B	AA-	15.7500%	6.25%	54,189,437	5.095%	9.919	2.797%	4.747%	7.665	195.00	55,812,222	102.995%
C1	A	12.0890%	3.66%	31,741,872	5.117%*	9.919	2.797%	5.247%	7.577	245.00	31,742,302	100.001%
C2	A-	11.8750%	0.21%	1,855,579	5.117%*	9.919	2.797%	17.000%	5.941	17.000%	836,338	45.072%
D	BBB-	7.0000%	4.87%	42,267,761	5.117%*	9.919	2.797%	17.000%	5.941	17.000%	19,050,734	45.072%
E	BB	5.0000%	2.00%	17,340,620	4.250%	9.919	2.797%	17.000%	6.222	17.000%	7,015,638	40.458%
F	B	4.0000%	1.00%	8,670,310	4.250%	9.919	2.797%	17.000%	6.222	17.000%	3,507,819	40.458%
G	NR	0.0000%	4.00%	34,681,239	4.250%	9.919	2.797%	17.000%	6.222	17.000%	14,031,276	40.458%
IO-A	AAA	-	-	676,284,170	1.525%	7.487	2.173%	3.923%	3.737	175.00	58,226,975	8.610%
IO-B	AAA	-	-	130,054,648	0.009%	9.669	2.665%	5.365%	5.256	270.00	456,993	0.351%
IO-C	AAA	-	-	17,340,620	0.868%	9.669	2.680%	8.805%	4.390	612.50	1,078,510	6.239%
IO-D	AAA	-	-	43,351,549	0.868%	9.731	2.694%	18.194%	3.564	1550.00	1,906,787	4.418%
Total				867,030,987							888,836,113	102.515%

Face Needed	Value Needed	Agg Econ Value	Face %
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
0	0	5.00%	0.00%
1,855,579	836,338	5.00%	100.00%
42,267,761	19,050,734	4.91%	100.00%
17,340,620	7,015,638	2.76%	100.00%
8,670,310	3,507,819	1.97%	100.00%
34,681,239	14,031,276	1.58%	100.00%
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
104,815,508	44,441,806	5.00%	



## Exhibit 5: Retention Analysis - 76.8% 10 Year Loans

Pricing Run 3: Pricing at 17% Yield up to Single A (12.11% of the Deal); overall pricing 5 to 15bps tighter - Average loan spread **29.8bps** wider

Class Name	Ratings	C.E. Level	Size	Original Balance	Coupon	WAL	Swap Rate	Yield	Duration	Credit Spread/Yield	Final Price \$	Bond Price %	Face Needed	Value Needed	Agg Econ Value	Face %
A-1	AAA	30.0000%	5.35%	46,358,803	1.102%	2.619	0.544%	1.094%	2.561	55.00	46,358,221	99.999%	-	-	-	-
A-2	AAA	30.0000%	22.31%	193,458,615	2.962%	4.877	1.407%	2.307%	4.502	90.00	199,258,110	102.998%	-	-	-	-
A-3	AAA	30.0000%	36.05%	312,582,574	4.072%	9.812	2.778%	3.723%	7.989	94.55	321,952,639	102.998%	-	-	-	-
AAB	AAA	30.0000%	6.29%	54,521,700	3.683%	7.474	2.287%	3.2371%	6.440	95.00	56,157,347	103.000%	-	-	-	-
AM	AAA	22.0000%	8.00%	69,362,479	4.443%	9.919	2.797%	4.097%	7.914	130.00	71,438,163	102.993%	-	-	-	-
B	AA-	15.7500%	6.25%	54,189,437	4.995%	9.919	2.797%	4.647%	7.703	185.00	55,812,979	102.996%	-	-	-	-
C1	A	12.1138%	3.64%	31,526,869	5.074%*	9.919	2.797%	5.097%	7.608	230.00	31,780,316	100.804%	0	0	5.00%	0.00%
C2	A-	11.8750%	0.24%	2,070,582	5.074%*	9.919	2.797%	17.000%	5.953	17.000%	928,799	44.857%	2,070,582	928,799	5.00%	100.00%
D	BBB-	7.0000%	4.87%	42,267,781	5.074%*	9.919	2.797%	17.000%	5.953	17.000%	18,960,014	44.857%	42,267,781	18,960,014	4.90%	100.00%
E	BB	5.0000%	2.00%	17,340,620	4.250%	9.919	2.797%	17.000%	6.222	17.000%	7,015,638	40.458%	17,340,620	7,015,638	2.76%	100.00%
F	B	4.0000%	1.00%	8,670,310	4.250%	9.919	2.797%	17.000%	6.222	17.000%	3,507,819	40.458%	8,670,310	3,507,819	1.97%	100.00%
G	NR	0.0000%	4.00%	34,681,239	4.250%	9.919	2.797%	17.000%	6.222	17.000%	14,031,276	40.458%	34,681,239	14,031,276	1.58%	100.00%
IO-A	AAA	-	-	676,284,170	1.517%	7.483	2.172%	3.922%	3.753	175.00	58,138,331	8.597%	-	-	-	-
IO-B	AAA	-	-	130,054,648	0.033%	9.669	2.665%	5.365%	5.059	270.00	684,587	0.526%	-	-	-	-
IO-C	AAA	-	-	17,340,620	0.824%	9.669	2.680%	8.805%	4.304	612.50	1,028,600	5.950%	-	-	-	-
IO-D	AAA	-	-	43,351,549	0.824%	9.731	2.694%	18.194%	3.567	1550.00	1,818,092	4.212%	-	-	-	-
Total				867,030,987							888,870,930	102.519%	105,030,512	44,443,546	5.00%	

Pricing Run 4: Pricing at 7.00% B-Piece at 17% Yield & BBB- at 10% Yield (approximately **14.21% Blended Yield**)- Average loan spread **8.3bps** wider

Class Name	Ratings	C.E. Level	Size	Original Balance	Coupon	WAL	Swap Rate	Yield	Duration	Credit Spread/Yield	Final Price \$	Bond Price %	Face Needed	Value Needed	Agg Econ Value	Face %
A-1	AAA	30.0000%	5.54%	48,026,581	1.101%	2.617	0.544%	1.094%	2.558	55.00	48,025,651	99.998%	-	-	-	-
A-2	AAA	30.0000%	22.28%	193,158,078	2.962%	4.877	1.407%	2.307%	4.502	90.00	198,948,580	102.998%	-	-	-	-
A-3	AAA	30.0000%	35.73%	309,764,069	4.122%	9.812	2.778%	3.773%	7.968	99.55	319,045,666	102.996%	-	-	-	-
AAB	AAA	30.0000%	6.46%	55,972,965	3.682%	7.470	2.286%	3.2360%	6.437	95.00	57,651,446	102.999%	-	-	-	-
AM	AAA	22.0000%	8.00%	69,362,479	4.544%	9.919	2.797%	4.197%	7.875	140.00	71,441,769	102.998%	-	-	-	-
B	AA-	15.7500%	6.25%	54,189,437	4.859%*	9.919	2.797%	4.747%	7.707	195.00	55,171,634	101.813%	-	-	-	-
C	A-	11.8750%	3.88%	33,597,451	4.859%*	9.919	2.797%	5.247%	7.642	245.00	32,917,322	97.976%	-	-	-	-
D1	BBB	10.3154%	1.56%	13,521,878	4.859%*	9.919	2.797%	6.797%	7.438	400.00	11,785,389	87.158%	-	-	-	-
D2	BBB-	7.0000%	3.32%	28,745,885	4.859%*	9.919	2.797%	10.000%	7.000	10.000%	19,875,205	69.141%	28,745,885	19,875,205	5.00%	100.00%
E	BB	5.0000%	2.00%	17,340,620	4.250%	9.919	2.797%	17.000%	6.222	17.000%	7,015,638	40.458%	17,340,620	7,015,638	2.76%	100.00%
F	B	4.0000%	1.00%	8,670,310	4.250%	9.919	2.797%	17.000%	6.222	17.000%	3,507,819	40.458%	8,670,310	3,507,819	1.97%	100.00%
G	NR	0.0000%	4.00%	34,681,239	4.250%	9.919	2.797%	17.000%	6.222	17.000%	14,031,276	40.458%	34,681,239	14,031,276	1.58%	100.00%
IO-A	AAA	-	-	676,284,170	1.276%	7.463	2.168%	3.918%	3.627	175.00	47,019,357	6.953%	-	-	-	-
IO-B	AAA	-	-	130,054,648	0.000%	9.669	2.665%	5.365%	-	270.00	-	0.000%	-	-	-	-
IO-C	AAA	-	-	17,340,620	0.609%	9.669	2.680%	8.805%	4.416	612.50	782,052	4.523%	-	-	-	-
IO-D	AAA	-	-	43,351,549	0.609%	9.731	2.693%	18.193%	3.567	1550.00	1,379,962	3.197%	-	-	-	-
Total				867,030,987							888,598,768	102.488%	89,436,054	44,429,938	5.00%	

## Exhibit 5: Retention Analysis - 76.8% 10 Year Loans

Pricing Run 5: Pricing at 7.00% B-Piece at 17% Yield & BBB- 10% Yield; overall pricing 5 to 25bps tighter - Average loan spread **4bps** wider

Class Name	Ratings	C.E. Level	Size	Original Balance	Coupon	WAL	Swap Rate	Yield	Duration	Credit Spread/Yield	Final Price \$	Bond Price %
A-1	AAA	30.0000%	5.58%	48,362,973	1.101%	2.616	0.543%	1.093%	2.557	55.00	48,362,217	99.998%
A-2	AAA	30.0000%	22.27%	193,097,402	2.962%	4.877	1.407%	2.307%	4.502	90.00	198,886,092	102.998%
A-3	AAA	30.0000%	35.66%	308,197,885	4.072%	9.812	2.778%	3.723%	7.989	94.55	318,469,229	102.999%
AAB	AAA	30.0000%	6.49%	56,263,432	3.682%	7.469	2.286%	3.2358%	6.437	93.69	57,951,220	103.000%
AM	AAA	22.0000%	8.00%	69,362,479	4.443%	9.919	2.797%	4.097%	7.914	130.00	71,438,163	102.993%
B	AA-	15.7500%	6.25%	54,189,437	4.816%*	9.919	2.797%	4.647%	7.731	185.00	55,412,761	102.257%
C	A-	11.8750%	3.88%	33,597,451	4.816%*	9.919	2.797%	5.147%	7.668	235.00	33,057,247	98.392%
D1	BBB	10.3308%	1.54%	13,389,091	4.816%*	9.919	2.797%	6.547%	7.481	375.00	11,847,042	88.483%
D2	BBB-	7.0000%	3.33%	28,878,670	4.816%*	9.919	2.797%	10.000%	7.012	10.000%	19,887,949	68.867%
E	BB	5.0000%	2.00%	17,340,620	4.250%	9.919	2.797%	17.000%	6.222	17.000%	7,015,638	40.458%
F	B	4.0000%	1.00%	8,670,310	4.250%	9.919	2.797%	17.000%	6.222	17.000%	3,507,819	40.458%
G	NR	0.0000%	4.00%	34,681,239	4.250%	9.919	2.797%	17.000%	6.222	17.000%	14,031,276	40.458%
IO-A	AAA	-	-	676,284,170	1.268%	7.459	2.167%	3.917%	3.647	175.00	46,961,161	6.944%
IO-B	AAA	-	-	130,054,648	0.000%	9.669	2.665%	5.365%	-	270.00	-	0.000%
IO-C	AAA	-	-	17,340,620	0.566%	9.669	2.680%	8.805%	4.422	612.50	733,014	4.240%
IO-D	AAA	-	-	43,351,549	0.566%	9.731	2.683%	18.193%	3.593	1550.00	1,292,820	2.995%
Total				867,030,987							888,853,647	102.517%

Face Needed	Value Needed	Agg Econ Value	Face %
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
28,878,670	19,887,949	5.00%	100.00%
17,340,620	7,015,638	2.76%	100.00%
8,670,310	3,507,819	1.97%	100.00%
34,681,239	14,031,276	1.58%	100.00%
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
89,570,839	44,442,682	5.00%	

\*WAC Bonds